

International Credit Analysis

Kingdom of Lesotho

Ratings

Foreign Currency

Long-TermBB-

Short-Term B

Outlook.....Negative

Local Currency

Long-TermBB+

Outlook.....Negative

Country Ceiling A-

Peer Group

BB
Azerbaijan
Colombia
Costa Rica
Peru
Philippines

BB-
Lesotho
Brazil
Indonesia
Serbia
Turkey
Ukraine
Vietnam

B+
Cape Verde
Ghana
Mongolia
Uruguay
Venezuela

Ratings History

Date	LTFC	LTLC
30 Nov 2004	BB-	BB+
02 Sept 2002	B+	BB

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■ Summary

Fitch has assigned a negative outlook to Lesotho's 'BB-' sovereign rating, reflecting the impact of the external shock to the textiles sector. Despite the duty-free access advantage Lesotho enjoys under the Africa Growth and Opportunity Act (AGOA) trade initiative, the expiry of the quota system under the multi-fibre agreement (MFA) at end-2004 has had a much worse-than-expected impact on Lesotho's textiles and clothing sector. The strength of the loti – which is pegged to the rand – adds to pressure on competitiveness. This has resulted in the closure of a number of factories, a substantial number of job losses and a slowdown in economic growth, which is now estimated to come in at 1% this year. Government interventions to support manufacturers seem to have arrested the closure of factories, but monthly textiles exports (comprising 73% of total exports in 2004) have stabilised at a much lower level than at the end of last year: exports for H105 reflected a 13% year-on-year decline.

Other macroeconomic aspects are, however, fairly benign. The budget is expected to continue to achieve moderate surpluses over the next two fiscal years as a result of strong Southern African Customs Union (SACU) revenues and public debt ratios to remain moderate. Diamond exports which started in H204 should help offset the decline in textiles exports this year. The build-up of official reserves and banks' foreign assets allowed Lesotho to become a net external creditor last year which is an important rating strength.

■ Credit Outlook

Structural reforms to restore the competitiveness of the economy following the expiry of the MFA and strengthening in the rand, remain a major medium-term challenge. Failure to counter the effect of the external shock would lead to a gradual build-up of pressure on the balance of payments and foreign exchange reserves. Further evidence of stabilisation or even reversal of the situation in the textiles sector should support changes in Lesotho's rating outlook.

■ Strengths

- Relative political stability since 2002 elections
- Strong integration with the South African economy
- Strong fiscal consolidation
- Net external creditor/strong international liquidity

■ Weaknesses

- External shock to the textiles sector
- Fiscal and external financing dependent on declining SACU revenues
- Public expenditure management although improving is still weak
- Structural reform challenges needed to improve the competitiveness of the economy
- Significant developmental and social challenges

Key Indicators for Lesotho

Population (2004): 2.3m

Population Growth Rate (2000-2004): 1.8% p.a.

GDP (2004): USD1.4bn

GDP per Head at Market Exchange Rates (2004): USD602

GNI Per Head at Purchasing Power Parity (2004): USD3,210 (= 8% of USA level)

Modern Sovereign Rescheduling History: None

	2001	2002	2003	2004	2005 ^f	2006 ^f	2007 ^f
Domestic Economy and Finance							
Real GDP Growth (%)	3.2	3.5	3.1	3.2	1.0	1.9	2.3
Unemployment (% of Labour Force)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Consumer Prices (Annual Average % Change)	5.9	11.7	7.3	5.0	4.2	4.6	4.0
Gross Domestic Savings (% of GDP)	-16.3	-18.0	-12.2	-7.5	-7.5	-6.5	-4.9
Gross Domestic Investment (% of GDP)	40.2	42.3	44.8	41.0	40.8	40.6	40.7
Short-Term Interest Rate (%) ⁽¹⁾	11.0	12.2	9.8	7.5	7.0	7.5	7.5
Broad Money (% Change Dec to Dec)	17.2	8.8	6.0	3.3	3.0	3.0	3.0
LSL per USD (Annual Average)	8.61	10.54	7.56	6.46	6.40	6.90	7.00
REER (CPI, 2000=100)	86.7	75.9	102.5	110.0	103.4	101.3	99.3
REER: % Change (+ = Appreciation)	-13.3	-12.4	35.0	7.3	-6.0	-2.0	-2.0
Public Finances							
General Government Balance (% of GDP)	0.7	-4.4	0.9	4.0	0.9	0.5	-4.5
General Government Debt (% of GDP)	101.4	73.8	65.1	53.0	44.4	42.9	45.0
General Government Debt Maturities (% of GDP) ⁽²⁾	12.7	15.4	10.1	10.5	8.0	6.8	5.0
General Government Debt/Revenue (%)	223.7	163.4	145.9	107.2	89.2	89.8	103.2
Interest Payments/Revenue (%)	6.8	6.6	6.0	3.1	3.6	3.7	4.6
Balance of Payments							
Current Account Balance (USDm)	-95.1	-126.7	-134.7	-76.0	-93.4	-103.9	-143.0
Current Account Balance (% of GDP)	-12.5	-18.1	-12.7	-5.5	-6.4	-7.1	-9.1
Current Account Balance plus Net FDI (USDm)	21.8	-42.6	-19.0	47.5	0.6	-4.9	-44.0
Current Account Balance plus Net FDI (% of GDP)	2.9	-6.1	-1.8	3.5	0.0	-0.3	-2.8
Gross Financing Requirement (% of Reserves) ⁽³⁾	34.0	45.3	45.1	25.0	30.7	29.2	33.5
Current External Receipts CXR (USDm)	692	722	1001	1401	1324	1356	1354
Current External Receipts CXR (Annual % Change)	1.4	4.4	38.6	40.0	-5.5	2.5	-0.2
Current External Payments CXR (USDm)	787	849	1136	1477	1417	1460	1497
Current External Payments CXR (Annual % Change)	-5.6	7.9	33.8	30.0	-4.1	3.0	2.5
External Assets and Liabilities							
Gross External Debt (USDm)	516.3	595.8	680.1	722.3	682.2	692.2	711.2
Gross External Debt (% of GDP)	67.7	85.2	63.9	52.7	46.4	47.1	45.5
Gross External Debt (% of CXR)	74.6	82.5	68.0	51.6	51.5	51.0	52.5
Net External Debt (USDm)	64.7	113.1	93.7	-3.2	-62.8	-67.8	-48.8
Net External Debt (% of GDP)	8.5	16.2	8.8	-0.2	-4.3	-4.6	-3.1
Net External Debt (% of CXR)	9.4	15.7	9.4	-0.2	-4.7	-5.0	-3.6
Public External Debt (USDm)	507.8	584.2	645.6	698.2	653.1	659.1	674.1
Public External Debt (% of GDP)	66.6	83.5	60.6	51.0	44.4	44.8	43.1
Net Public External Debt (% of CXR)	17.5	24.6	18.5	13.9	10.1	9.5	10.6
Public FC Denominated & FC Indexed Debt (USDm)	507.8	584.2	645.6	698.2	618.2	616.1	674.1
Short-Term External Debt (% of Gross External Debt)	3.9	3.4	2.9	2.8	2.9	2.9	2.8
External Debt Service (% of CXR)	8.7	8.5	6.2	4.7	6.5	5.4	4.4
External Interest Service (% of CXR)	2.0	1.8	1.4	1.9	1.9	1.8	1.8
Liquidity Ratio (%) ⁽⁴⁾	735.1	555.5	585.0	685.9	684.5	803.7	955.5
Official International Reserves Including Gold (USDm)	386	406	460	503	520	530	530
Official International Reserves in Months of CXP Cover	5.9	5.7	4.9	4.1	4.4	4.4	4.2
Official International Reserves (% of Broad Money)	235.2	161.9	133.0	119.3	140.4	151.6	153.3

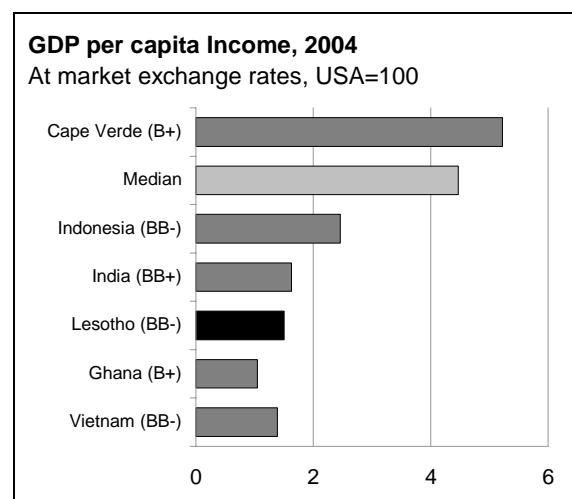
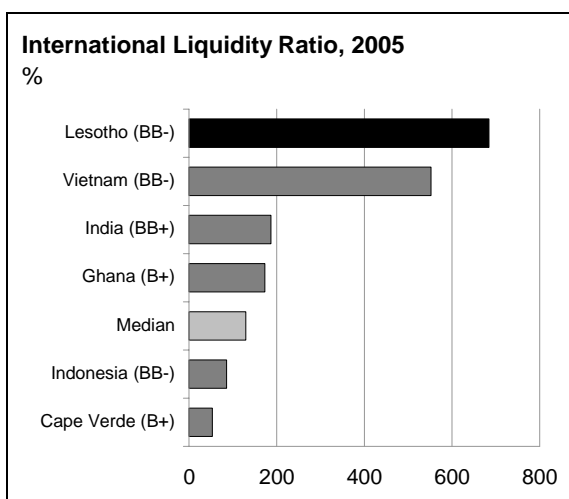
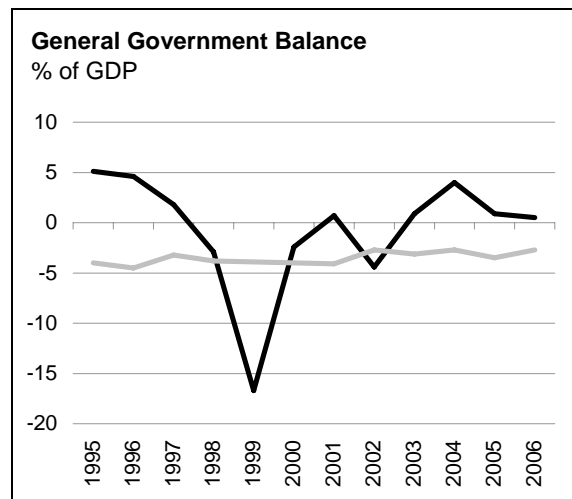
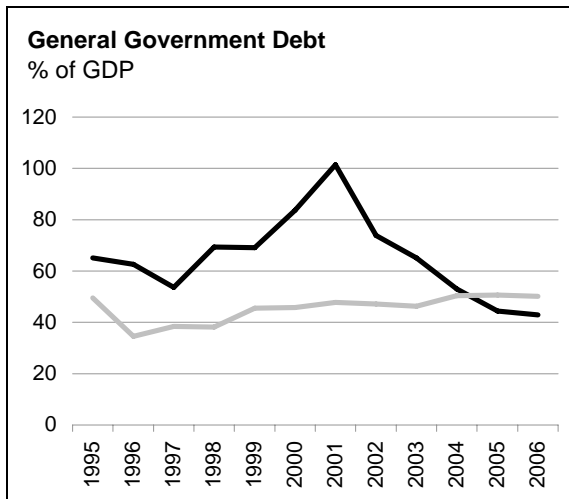
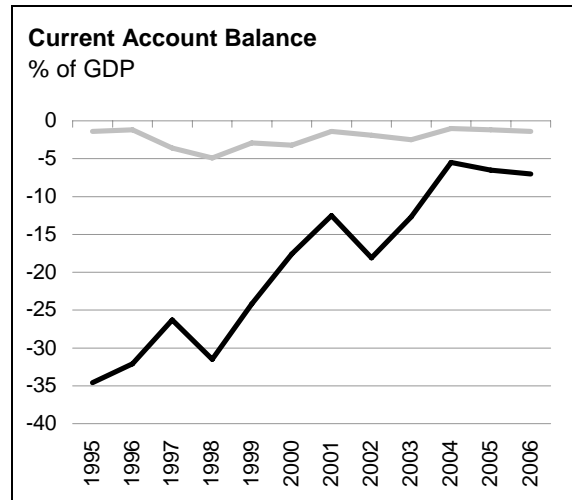
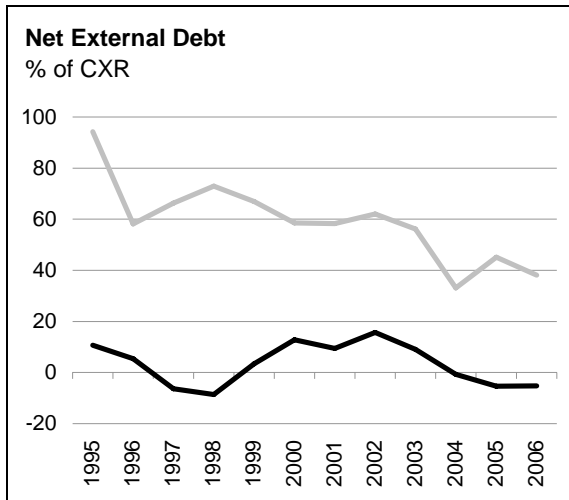
⁽¹⁾ Short-term treasury bill rate (end year).

⁽²⁾ Maturities of medium and long-term debt during year plus short-term debt outstanding at the beginning of the year.

⁽³⁾ Current account balance plus amortisation of medium and long-term debt, over official international reserves.

⁽⁴⁾ Official reserves including gold plus banks' foreign assets/ Debt service plus liquid external liabilities.

Peer Comparison



— Lesotho

— BB Median

Source: Fitch Sovereign Comparator

■ Rationale

Fitch has assigned a negative outlook to Lesotho's 'BB-' long-term foreign currency rating, reflecting the impact of the external shock to the textiles sector. Despite the duty-free access advantage Lesotho enjoys under the Africa Growth and Opportunity Act (AGOA)¹ trade initiative, the expiry of the quota system under the multi-fibre agreement (MFA) at end-2004 has had a much worse-than-expected impact on Lesotho's textiles and clothing sector. This has resulted in the closure of a number of factories, a substantial number of job losses and a slowdown in economic growth, which is now estimated to come in at around 1% this year.² This comes on top of reduced competitiveness of the textiles sector as a result of the strengthening of the loti (rand). Government interventions to support manufacturers seem to have arrested the closure of factories, but monthly textiles exports (comprising 73% of total exports in 2004) have stabilised at a much lower level than at the end of last year: exports for H105 reflected a 13% year-on-year decline.

Other macroeconomic aspects are, however, fairly benign. The budget achieved a strong surplus in 2004/05, the result of a budgeted-for customs revenue windfall and substantial under spending. Further modest budget surpluses are also expected over the next two fiscal years. Exports grew strongly in 2004 in the textiles industry and diamond sector, which started up in H204. The first full year of diamond exports should help offset the decline in textiles exports this year. Public debt ratios have continued to decline, owing to currency appreciation and the repayment of domestic bonds. The build-up of official reserves and banks' foreign assets allowed Lesotho to become a net external creditor last year.

The government has intervened directly to support manufacturers by easing the actual cost of operating their factories, as well as adopting measures intended to ease bureaucracy. It has also adopted strategies aimed at improving competitiveness over the medium term – for example co-financing training programmes organised by clothing and textiles companies. Funding from the US Millennium Challenge Corporation (MCC) is earmarked for the exploitation of water resources for industrial usage and to support reforms aimed at improving the overall business environment. Lesotho has made progress on vertical integration with the completion

of a denim mill last year. This meets most of the denim sector's requirements, accounting for 30% of output, and also better places Lesotho to meet the new criteria that will come into force in 2007 whereby AGOA countries may only source fabrics from the US and other AGOA-eligible countries to qualify for duty-free access to the US.

However, factories still face reduced orders and it is too early to tell whether the decline has bottomed out. In addition, competition will continue to intensify owing to the trend towards globally lower tariffs over the longer term – which will diminish the advantage of duty-free access to the US. Thus the pace of activity in the sector will be much slower than in the past three years. Further evidence of stabilisation or even a reversal in the situation of the textiles sector would support changes in Lesotho's rating outlook.

Other medium- and long-term constraints relate to poverty and social challenges, as well as high unemployment. Food security remains a problem after four years of erratic weather and is also linked to the low purchasing power of rural households. The dismissal of around 10,000 people in the textiles sector since the beginning of the year has worsened already-high unemployment. With GDP per capita of USD600 in 2004, Lesotho is much poorer than its rating peers; the 'BB' median is USD1,775. And despite progress on some indicators such as education and access to water, the country's Human Development Ranking (HDR) has deteriorated owing to the impact of HIV/Aids on life expectancy.

On a positive note, the Letseng diamond mine became operational last year, helping diversify export earnings and expand the government's revenue base. It is also timely, in that it will help offset the impact on textiles exports of the expiry of the MFA. Around USD90 million worth of diamonds were exported in the H204, accounting for around 12% of total 2004 exports, and this mine is typically expected to export around USD120m-USD150m of diamonds annually. Negotiations on investment into another diamond mine, the Liqhobong, are at an advanced stage.

The rating continues to be supported by the country's strong fiscal position. Lesotho will continue to benefit from stronger-than-normal South African Customs Union (SACU) revenues over the next two fiscal years, resulting in budget surpluses for the four years between 2003/04 and 2006/07.³

¹ The AGOA trade initiative, which was enacted in 2001, gives duty and quota-free access to the US to the textiles and many other products to 37 eligible sub-Saharan African countries.

² Manufacturing, (mainly textiles and clothing) accounts for around 20% of GDP but substantial job losses have had a spill-over effect on the broader economy .

³ In 2003/04 to 2004/05 owing to a budgeted-for SACU windfall; in 2005/06-2006/07 owing to an adjustment related to the transition to a new revenue formula.

Peer Comparator 2005 – Fiscal and External Debt Indicators

	Lesotho	BB Median
GXD/GDP	46.4	40.7
NXD/CXR	-4.3	45.1
Debt Service/CXR	6.5	11.9
Liquidity Ratio	685	118
General Gov't Balance/GDP	0.9	-3.5
General Gov't Debt/GDP	44.4	50.8
General Gov't Debt/Revenue	89.2	229

Source: Fitch

The government has been implementing public finance reforms since 2001/02 and has made some progress; however, much more needs to be done to strengthen systems and processes so as to enhance the efficiency and effectiveness of public expenditure and enable Lesotho to adjust to a decline in SACU revenues over the medium to longer term. Following local government elections in April, the decentralisation of social services delivery will be the country's major challenge. Public debt ratios are below the median for the 'BB' category, although the high foreign currency share exposes public debt to exchange rate risk. Given Lesotho's moderate borrowing, they should remain fairly stable over the medium term. Lesotho's public debt position is considerably stronger when considering government deposits with the banking system equivalent to 15% of GDP at end 2004/05.

Gross external debt ratios have fallen substantially, to 53% of GDP in 2004 from 85% in 2002, largely reflecting the loti's strong appreciation in the intervening period. External debt, which is predominantly public, should decline in nominal terms this year owing to the government's decision to prepay debt taken out on commercial terms in 1996 to save on interest costs. Gross external debt is therefore projected to decline to 46% of GDP at end-2005. The 'BB' median is 41%.

The moderation of external debt as well as a substantial increase in banks' foreign assets and the build-up of official reserves allowed Lesotho to become a net external creditor last year for the first time since 1998, which is a rating strength and, at this rating level, is typically associated with oil-producing countries. Net public external debt ratios are also relatively low, at around 14% of both GDP and current account receipts (CXR), compared with 'BB' medians of 14% and 34%, respectively. External liquidity remains strong. Despite the decline in textiles exports, strong SACU revenues over the next two years and diamond exports should help support the balance of payments and Lesotho's international liquidity position.

■ Political and Social Situation

Lesotho has enjoyed relative political stability since the 2002 elections, which introduced an element of proportional representation into the electoral system, thereby ensuring a broader representation in parliament. Nevertheless, the ruling party, Lesotho Congress for Democracy (LCD), remains very dominant, while the Basotho National Party (BNP), the main opposition party, is less well organised and ineffective. In April, local government elections were conducted for the first time for 129 city councils, with one-third of the seats reserved for women. The ruling party won by an overwhelming majority although the turn out was low (40%-45% overall and 30% in Maseru). Administrative structures are still being put in place and donor support will focus on strengthening them, to ensure that the local administrations play an important role in service delivery and poverty reduction. The next general elections are in 2007.

Social and developmental challenges pose a significant constraint to Lesotho's ratings. The main social issues in Lesotho remain food security caused by erratic weather, particularly in the rural, mountain areas, soil degradation and erosion, and HIV/Aids. Owing to its limited arable land Lesotho has for a long time been a net food importer for around 60% of its annual cereal consumption. In terms of food security, relief from the government and international agencies is targeted at around 550,000 vulnerable people including older citizens, HIV/Aids orphans and schoolchildren. This relief accounts for 5%-10% of the food supply but goes to the more remote areas, introducing little distortion into the market. The recently completed Poverty Reduction Strategy (PRS) has introduced strategies for increasing agricultural productivity that include more appropriate farming methods, such as low-cost irrigation techniques and crop diversification into higher value-added crops, as well as land tenure reform aimed at improving access to land and reducing gender inequalities in land ownership.

Lesotho has one of the highest HIV/Aids infection rates in the world estimated at 30% of the adult population. Around 2% of the government's budget is earmarked for implementing the National Aids Strategic Plan; the government is also receiving funding from the Global Aids Fund and bilateral donors for the prevention and treatment of the disease, and the care of HIV/Aids orphans. However, organisational and capacity problems have hampered progress in this area – a National Aids Secretariat has only recently been set up to coordinate the effort. Lesotho moved down four places to 149 on the 2005 UN HDR, mainly because of lower life expectancy attributable to HIV/Aids, although other indicators

such as the literacy rate are at the middle-income country level.

Other social challenges relate to poverty and the high level of unemployment estimated at around 30%. Lesotho is a low-income country with GDP per capita of USD600 and GNI per capita of USD850 in 2004. Despite positive per capita growth over a long period, the retrenchment of miners in South Africa over the past decade plus the weak performance of agriculture in recent years has caused a decline in rural incomes. Five-per capita growth averaged just 0.6%. The dismissal of around one-fifth of the workforce in the textiles sector this year has worsened already high unemployment in the country's urban areas. The PRS, which is to guide medium-term development and was prepared after broad-based consultation with the private sector, donors and civil society, articulates strategies to address priority areas. These include agriculture and food security, infrastructure, governance, the environment, service delivery considered important for increasing growth and employment, and poverty reduction.

In May Lesotho signed an agreement with the US Millennium Challenge Corporation (MCC) for funding under the MCA⁴. This grant is given by the US based on the government's own proposals for promoting private investment, sustaining growth and reducing poverty. In Lesotho the funds thus obtained are earmarked for exploitation of the country's water resources and long-term improvement in its competitiveness. Most of the funding will go towards the construction of the Metolong Dam Project, which will provide water for industrial and domestic usage in the lowlands around Maseru. It will also provide support for institutional and structural reforms aimed at maximising the benefits of the increased water supply by improving the private investment climate. Key areas identified are further reforms to the financial sector, including setting up regulations for leasing and a regime for mortgages and other collateral, reforms to the judiciary, land reform, including a gender act that will make it easier for women to access credit, streamlining immigration and building capacity.

Lesotho is strongly integrated with the South African economy, benefiting from its access to South Africa's sound transport infrastructure as well as its membership of a common currency area, which has helped in terms of credibility and price stability. It

⁴ MCA funding from the US is available to a selected number of developing countries on the basis of their commitment to strong governance, human rights protection, rule of law and an open economic system.

also belongs to the SACU, from which it obtains strong customs revenues. All these factors are considered rating strengths. The South African government's investment in the Lesotho Highlands Water Project (LHWP), which provides water to the Gauteng area, is not only a source of revenue for Lesotho but has also resulted in an upgrade of transport infrastructure in the rural areas. The Muela Hydropower Dam, which has made Lesotho self sufficient in electricity, was another spin-off of the project.

■ Short-Term Prospects

Lesotho experienced a severe negative external shock as a result of the elimination of the global textiles quota system on 31 December 2004. Around five factories were closed down towards the end of last year and in the first quarter of this year as buyers withheld their orders in the lead-up to the deadline, resulting in a loss of output and around 10,000 jobs. This has had substantial spill-over effects on the broader economy, leading to a significant deterioration in Lesotho's short-term growth outlook. The government has implemented several measures aimed at supporting manufacturers and no further closures have occurred since April 2005, although the remaining factories are dealing with fewer orders. GDP growth is now projected at 1%, down from an earlier estimate of around 4%, rising to around 2% next year.

Economic Performance and Outlook

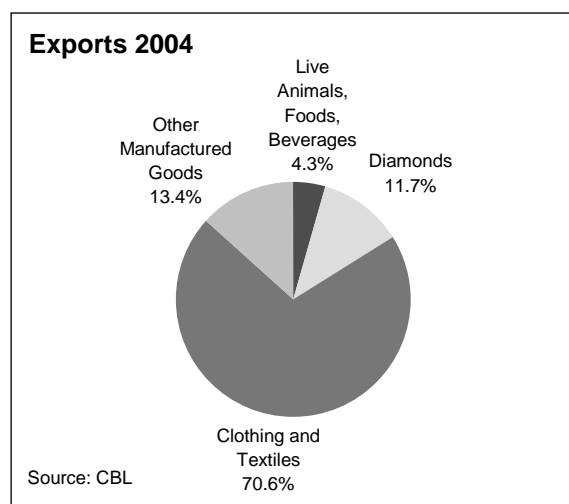
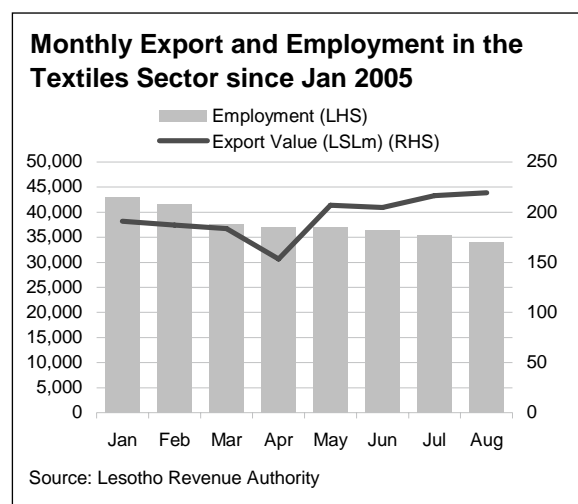
	2004	2005f	2006f
Real GDP (%)	3.2	1.0	1.9
CPI Inflation (% Annual Avg.)	5.0	4.2	4.6
Budget Balance (% GDP)	4.0	0.9	0.5
Current Account (% GDP)	-5.5	-6.4	-7.1

Source: CBL, MoF, Fitch estimates and forecasts

Other aspects of the macroeconomic environment are relatively benign. The exchange rate, which is pegged to the rand, has depreciated moderately this year, which may have eased pressure on exporters slightly. Inflation is expected to rise in line with trends in South Africa as a result of higher oil prices, but should remain relatively low. Similarly, interest rates – currently at their lowest level for over 20 years – look set to remain relatively low. The first full year of diamond exports will help offset lower textiles exports, but the current account is expected to widen to 6.5% of GDP from 5% in 2004.

■ Structural Issues

The expiry of the MFA, which eliminated quotas on textiles exports, at end-2004 had a much worse-than-expected impact on Lesotho's textile sector, despite the continued advantage of duty-free access to the



US under AGOA. The manufacturing Sector was already struggling from the impact of the strong currency appreciation on export competitiveness and its own profitability, as the rise in local costs caused margins to fall. After posting continued expansion during 2004 in terms of both exports and employment, three factories in this sector closed down in December 2004 and another two in the first half of 2005 in response to the a decline in orders from buyers. This has led to a loss of around 10,000 jobs since the end of last year. H105 textiles exports were down 13% year on year, although they have recovered slowly since May 2005. H105 textiles and clothing exports were worth USD204m compared with USD514m for the whole of 2004.⁶ Textiles exports had risen from USD215m in 2001 (the first year of AGOA) and employment in the sector from 28,500 people in 2001 to 45,100 at end-2004.

The government has intervened directly to curb the closure of factories by freezing rentals and export-tariffs, introducing concessions on the duties payable on the imports for inputs, and easing bureaucracy and improving logistical support by speeding up the process of setting up a one-stop shop and export processing zones. Trade delegations have been sent to the US to court current and prospective buyers and the government has hired two US companies to promote Lesotho as an investment destination. These measures seem to have stabilised the situation. However, activity in the textiles sector for full-year 2005 will be considerably lower than in the past three years.

This external shock and the global trend towards lower tariffs over the longer term (which will diminish the advantage of duty-free access to the

US) have caused the government to focus on adapting to the much more competitive environment facing the textiles and clothing sector. It is co-financing training programmes organised by clothing and textiles companies for their employees as a way of increasing productivity. Funding from the MCC has been earmarked for water development and to finance trade and investment reform programmes (see *Political and Social* section). The government continues to pursue the diversification of the exports markets through preferential trade agreements, although textiles products would still face much stiffer competition. The completion of a denim mill last year better places Lesotho to meet new criteria due for introduction in 2007 whereby AGOA countries will only be able to source fabrics from the US and other AGOA-eligible countries in order to qualify for duty-free access to the US.

The Letseng diamond mine, which involved a USD210m investment, became operational last year. This is timely in that it will help offset the impact on textiles exports of the expiry of the MFA and, more generally, help diversify exports and expand the government's revenue base.⁷ Typically, this mine is expected to export USD120m-USD150m in diamonds annually. Around USD90m worth of diamonds were exported in H204 and the mining sector's share of GDP was around 2%, up from virtually zero in 2003. Negotiations on another diamond mine, the Liphobong, are at an advanced stage and it is expected to open next year. Three other diamond mines are also earmarked for investment.

The other major sectors include agriculture, accounting for around 15% of GDP and providing a

⁶ According to CBL balance of payments data.

⁷ The government derives revenues from a 7% royalty on the sale of diamonds, corporate tax, rental of the area and the dividends it receives as a shareholder in the mine.

livelihood for around 50% of the population. This sector has suffered from a fourth consecutive year of poor weather as well as poor farming techniques. After several years of decline, it grew by just 0.5% last year; given the large proportion of the population that depends on this sector, its weakness has contributed to the lack of progress on poverty reduction. Miners' remittances, which make a large contribution to GNI and are a major source of rural income, were supported by higher average earnings, which increased by 11%. However, employment levels among miners have continued to fall over the past year, slipping below 60,000 for the first time in 2004 as a result of weaker profitability in the South African mining sector.

The bidding process for one of the few remaining major parastatals, the Lesotho Electricity Company (LEC), has been extended until end-November. The successful bidder will acquire a 70% stake in LEC on an operating concession basis for 20 years. LEC has undergone a lengthy restructuring to improve its efficiency, and tariffs were increased by 18% in January 2004 and 2005 in preparation for the privatisation. They are expected to reach full cost recovery following a further tariff increase in January 2006. Rural electrification will be financed through the budget and funding from donors. The remaining privatisations are much smaller and include hotels, an insurance company and a pharmaceuticals company.

■ Financial Sector

Lesotho's banking sector is mostly foreign owned, comprising subsidiaries of three major South African banks and Standard Chartered Bank (UK). These parent banks are well supervised and capitalised and therefore pose little risk to the sovereign in terms of contingent liabilities and systemic risk. The sector is also healthy, with a high capital adequacy ratio, low NPL ratio and high profitability.

However with M2/GDP at 27% as of end-2004 and domestic credit to the private sector/GDP at just 5.1%, the banking sector is small and poorly developed. Private sector credit growth picked up to 35% year on year in June, mainly owing to expansion in the household sector (up 56% y-o-y, mainly hire purchase), which reflects the relatively low interest rates. However, lending levels remain very low, owing to a variety of structural and legislative impediments to financial intermediation. Consequently, financial sector reforms to improve credit extension are a key focus of the US MCC funding to Lesotho, which is aimed at fostering private investment. The funding will support initiatives such as credit bureaux, commercial courts and modernisation of the payments system (some of

which are already under way) as well as legislation on establishing a leasing system, and a more efficient mortgage regime, improving property rights and increasing the participation of women in the economy.

Key Facts: Banking System

	Dec 04
M2 (% GDP)	27
NPL Ratio	3
Capital Adequacy Ratio (%)	24.0
Public Ownership, % of Assets	5
Foreign Ownership, % of Assets	95

Source: CBL

In January 2005 the government set up the Lesotho Postal Bank (LPB) to extend financial services to rural areas using the postal services infrastructure. This sector had been unbanked since the liquidation of the Lesotho Agricultural Development bank in 1998. LPB is a deposit-taking bank and is allowed to invest only in government securities. As of end-Q105, four branches had been set up in Maseru and three in the rural areas. The LPB is fully government owned but in future, the government intends to run it as a joint venture with a technical partner. Although the establishment of the LPB is positive for development, its operating costs will add around LSL8m to annual government expenditure. It also raises contingent liability risks, calling for the need for strong supervision.

■ Public Finance

Lesotho achieved a budget surplus of 4%⁸ of GDP in 2004/05 (target 2.7%) owing to significant expenditure underperformance; this was attributable to one-off factors such as partial spending on local government elections, which took place in April (the 2005/06 fiscal year), the postponement of the National Identity card scheme and a substantial shortfall in capital expenditure. The government also achieved interest savings on foreign debt. It reported a slight shortfall in revenues from VAT, reflecting the economic downturn that started in Q404 and persisted into 2005, a lower water royalty owing to a decline in demand from South Africa and lower donor budget support. The very strong performance of revenue – almost 50% of GDP – was attributable to a budgeted SACU revenue windfall, which caused this revenue to rise to 22% of GDP from 18% in the previous year. Revenue performance also benefited from the continued impact of tax administration reforms on non-SACU revenue. The government

⁸ The IMF has revised this figure up to 9.1% of GDP, while the CBL places it at 8% based on the residual between financing and the overall gap. The government is still finalising its figures.

used this surplus to retire a LSL273m bond, issued to recapitalise Lesotho Bank five years ago⁹, while the remainder was deposited with the domestic banking system. Domestic debt declined to 4.6% of GDP at end-2004/05.

The 2005/06 budget will move to the medium-term budgetary expenditure framework (MTEF) for the first time, the aim being to improve the transparency and predictability of the budgetary process, enhance the productivity of public finances and align the budget to the government's poverty reduction strategy. The budget targets a deficit of 2.7% of GDP in 2005/06. According to the MTEF, Lesotho will have lower SACU revenue¹⁰ and smaller efficiency gains from non-SACU tax administration measures on the revenue side, while expenditure will rise by 15% in nominal terms owing to the full-year implementation of the old-age pension scheme, which started in November 2004, and the one-off partial costs of the local elections and other expenditure pressures on the social side. However, preliminary data for H105 evidence a much stronger fiscal position – primarily reflecting additional SACU revenue stemming from the transitional aspects of the new revenue formula as well as a shortfall in recurrent expenditure. Money corresponding to the transitional adjustment means that SACU revenues should be 16% and 18% higher, respectively, than the budgeted estimates for the next two fiscal years. After adjusting figures to reflect this, Fitch is estimating small surpluses in 2005/06 and 2006/07, while the IMF has recently revised its estimate for the 2005/06 budget outturn to a 5% surplus. These SACU adjustment revenues are, however, temporary and are expected to end altogether in 2006/07.

The medium- to longer-term outlook is less favourable. SACU revenues will decline owing to shrinkage in the revenue pool (see table below), although this will be offset somewhat by tax administration reforms that are already under way, and overall revenues are projected to remain strong, at 43.6% of GDP, by the end of the MTEF. The current MTEF projects deficits at 2.9% of GDP in 2006/07 and 4.5% in 2007/08 given an unchanged policy environment, although the 2006/07 figures are likely to be revised in lieu of the additional SACU revenue. The main problem stems from expenditure commitments where there is growing pressure from social spending – including the old-age pension

SACU

The SACU, which has existed since 1910, collects customs and excise taxes on behalf of Botswana, Lesotho, Namibia, Swaziland (BLNS) and South Africa and deposits them in a common revenue pool (CRP). The revenues are distributed among the member states according to their share of intra-SACU imports and excisable goods according a pre-determined revenue-sharing formula (RSF). SACU revenues will be affected by two factors.

1. Tariff reductions under the EU-South Africa free trade agreement, the SADC protocol and the US-SACU trade agreement (currently under negotiation), will reduce the size of the overall revenue pool.
2. The new SACU agreement, which came into effect in April 2005, makes changes in the RSF that will reduce the share of revenues for the BLNS countries by removing the compensatory element set at 42% of their CRP receipts. It will also make the transition to a democratic union, and will have more balanced obligations and decision-making powers in terms of trade policy, tariffs etc.

Under the new RSF, customs duties will continue to be based on each country's share of intra-SACU imports but South Africa's share will now be determined within the formula rather than as a residual. Excise duties will be split into two components: 85% will be shared according to each member's share of total SACU GDP; and the remaining 15% will form a development component, which will be distributed in inverse proportion to the member's GDP per capita.

scheme, plans to introduce free secondary school education, the ongoing scholarship scheme for higher education abroad and the possibility of continued food relief for the very vulnerable. However, Lesotho has very high revenue and expenditure to GDP ratios and there is scope for expenditure cuts and improvements in the efficiency of public spending. Much more must be done to enhance public expenditure management, improve the productivity of public finances and prioritise spending in line with the poverty reduction strategy.

Deficits at the level projected in the MTEF would jeopardise a fiscal strategy consistent with the government's macroeconomic policy objectives by crowding out the private sector and putting pressure on the balance of payments. The MTEF and the Central Bank of Lesotho's (CBL) Monetary Policy Committee (MPC) (see *Monetary and Exchange*

⁹ A LSL117m 10-year bond will fall due in 2009.

¹⁰ The new revenue formula came into force on 1 April 2005. Growth in SACU revenue will be lower thereafter, owing to the shrinking pool.

Rate Policy) have highlighted this well in advance, giving the government enough time to take action. Public finance reforms, the tendency to underspend and the scope for expenditure cuts should all help in this regard.

Public Finances: Sources and Uses

(LSLm)	2004/05	2005/06f	2006/07f
Uses	167.5	345.9	235.1
Budget Balance	-359.5	-87.3	-53.8
Amortisation	527.0	433.2	288.9
Domestic	273.0	0.0	0.0
External	254.0	433.2	288.9
Sources	167.5	345.9	235.1
Gross Borrowing	210.1	345.9	235.1
Domestic	0.0	70.9	-61.9
External	210.1	275.0	297.0
Change in Domestic Balances	-42.6	0.0	0.0

Source: MoF, IMF, Fitch estimates and forecasts

Over the medium term the net public sector borrowing requirement will be financed through new domestic borrowing. In 2005/06, in addition to making scheduled debt repayments, the government has pre-paid debt worth LSL150m (USD23m) to the Public Investment Commissioners (South Africa).

Public Sector Reforms

Lesotho embarked on a series of reforms in 2001/2002 aimed at improving transparency, governance and the efficiency of public finances. Accounts going back to 2001/2002 have been audited and treasury functions strengthened through the appointment of key personal. The government has also implemented a monthly revenue and expenditure reporting system and has set up an anti-corruption unit to root out corruption in the public sector and customs with the help of the South African Revenue Service. All these measures have helped tighten expenditure controls. The Lesotho Revenue Authority (LRA) has successfully raised non-SACU tax revenue. The multi-year budgetary framework launched this year should help align expenditure with national development objectives, while an integrated financial management system will be implemented over the next few years to improve operational efficiency. However, much more still needs to be done to strengthen the systems and processes in place. Recently the Ministry of Finance merged with Ministry of Development Planning and the departments were streamlined to 6 from 21, with a view to strengthening project implementation and social services delivery. Following decentralisation, public finance management at the local government level will be the next major challenge.

This debt was incurred by the Post Office in 1996 for 23 years at commercial interest rates and the purpose of the prepayment was to save on debt-servicing costs. Following a consolidation exercise with South Africa, the government has also assumed LSL230m (USD36m) in debt corresponding to the LHWP. As a result of lower domestic borrowing and net external debt repayments, public debt is projected to decline to 44% of GDP in 2005/06 from 53% in 2004/05, and to remain roughly stable over the medium term. In addition the government remained a net creditor to the banking system with deposits equivalent to 15% of GDP at end-2004/05. The public debt ratio is below the median of the 'BB' rating category which is 50% of GDP.

■ Monetary and Exchange Rate Policy

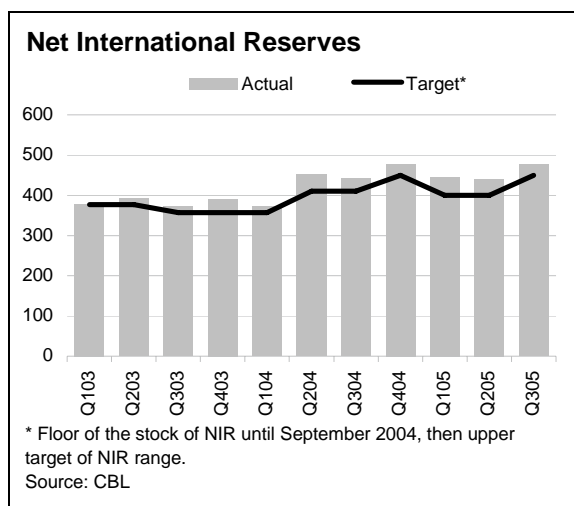
Lesotho is a member of the Common Monetary Area (CMA) that also includes South Africa, Namibia and Swaziland. Under this arrangement the individual currencies are pegged at par with the rand and circulate alongside it in their respective countries. There is free movement of capital within the CMA and its members' monetary policy is effectively that of South Africa – an inflation-targeting monetary regime that is transmitted to the CMA countries through interest rate changes. Over the past two years South Africa's monetary policy has delivered low inflation and the lowest interest rates in years to the CMA members.

The Central Bank of Lesotho's (CBL) main monetary policy objective is to preserve the peg. Its MPC, which sat for the first time in September 2004, meets quarterly and sets a net international reserve (NIR)¹¹ target range consistent with maintaining the peg, while also closely monitoring developments in the balance of payments. The NIR target was set at USD400m-USD450m in September 2004, but was lowered to USD350-USD400m (1.3 times broad money or M2) following the downturn in the garments sector in the early part of the year. Since then the short-term outlook for the balance of payments has improved owing to a much better-than-expected fiscal position, and the NIR target was returned to the USD400m-USD450m range at the last MPC meeting in September, equivalent to 1.4 times M2. The actual NIR has remained within or above the higher target range since September 2004.

More generally, however, concerns remain about the long-term balance of payments outlook following the

¹¹ Defined as liquid unencumbered foreign assets of the CBL less foreign liabilities. Prior to this the CBL set a floor on the stock of NIR based on the PRGF.

reduction in the competitiveness of the garments sector owing to the removal of the textiles quota system. The CBL estimates that this will cause the long-term current account deficit (excluding the LHWP) to widen to 6% from 5% in 1998-2004. Given the financing gap, which has increased since capital account liberalisation in 2003, this would result in a gradual decline of reserves, potentially threatening the maintenance of the peg. To counteract this situation, the MPC stressed the need for structural reforms to restore the competitiveness of the economy and to maintain a sound fiscal position. In this regard, the recent signing of the US Millennium Challenge Account (MCA) agreement, which focuses on private sector development in conjunction with a large water development, merited a positive mention in the MPC's September statement. The budget position must certainly be much stronger than that implied in the MTEF.



Inflation slowed to 3.3% at the end of July from 3.7% at the end of March, in line with price growth in South Africa, which accounts for roughly 80% of Lesotho's imports. This reflected lower imported inflation owing to the strength of the rand (loti). Domestically the main price pressures are from increases in administered transport prices and large increases in electricity and water tariffs. South Africa's CPIX inflation measure rose to 4.7% in September, largely reflecting rises in fuel prices. According to the South Africa Reserve Bank's latest projections it should peak at 5.5% in Q106, but remain within the target range of 3%-6% over the next three years, keeping inflation in Lesotho relatively low.

Similarly interest rates look set to remain relatively low. Interest rates in South Africa were cut to 7% in April; the subsequent combination of marginal weakening in the currency, a rapid rise in broad money (M3) and private credit growth (i.e. a

generally buoyant economy) mitigate the likelihood of a further easing for now. Rates on 91-day treasury bills fell to 6.99% in September (versus 6.75% in South Africa), which is consistent with a lower net borrowing requirement. The prime rate in Lesotho is 11.5% (versus 10.5% in South Africa), down from 12% at end-2004.

The loti (rand) has appreciated by around 25% since end-2002. After reaching a six-year high in December 2005, it has traded in a weaker range since Q205, mainly owing to the strengthening in the USD. Pressures on South Africa's current account deficit also suggest that the rand should remain relatively weaker than last year. The strength of the currency has been beneficial in terms of inflation and interest rates but has had a negative impact on Lesotho's much less diversified manufactured exports sector.

External Finance

Despite further currency appreciation, merchandise exports (70% of which are textiles) expanded by 27% in loti (rand) terms and 50% in USD terms last year. This reflected robust demand in the US and the launch of diamond exports in H204, which totalled around USD90m in that period. Import growth was 10% in loti (rand) terms, in line with the increase in imported raw materials for the textiles export sector and higher capital spending by the government. The trade deficit was very large at 43% of GDP, down from 49% in 2003. The two other major components of the current account are miners' remittances and SACU receipts, which accounted for roughly 20% and 15% of current account receipts, respectively. Despite retrenchments, miner's remittances expanded as a result of an increase in earnings, while SACU revenues were up 30%. This resulted in a substantial narrowing in the current account deficit to 5.5% of GDP from 12% in 2003.

This was fully financed by foreign direct investment (FDI) related to the diamond mine, textiles sector and LHWP. These inflows also offset an increase in net capital outflows related to the activities of commercial banks in 2004, which rose to USD50m (3.6% of GDP) from USD9m in the previous year.

The textiles exports sector has since been hit by the closure of a number of textiles firms in Q404 and early 2005 as well as the reduction in orders, which caused a sharp decline in overall exports in Q105. However, the performance of exports picked up slightly in Q205, mainly owing to the large increase in diamond exports; preliminary data show that exports grew by 6% year on year in H105. Imports slowed in line with lower exports, but the trade deficit, normally large, is expected to deteriorate

External Finances: Sources and Uses

(USDm)	2004	2005f	2006f
Uses	115	154	152
Current Account Balance	76	93	104
MLT Amortisation	39	61	48
Sources	115	154	152
Gross MLT Borrowing	38	21	58
Net FDI	123	94	99
Net Resident Lending Abroad	-49	-30	-30
Other Capital Net	42	60	40
Change in FX Reserves (- = Increase)	-39	9	-15

Source: CBL. Fitch estimates and forecasts

over the full year. However, strong SACU revenues should help contain the current account deficit at around 7% of GDP, which is still lower than it was prior to 2004.

Preliminary balance of payments data for H105 indicate an overall capital and financial account surplus, primarily owing to a reduction in commercial banks' net foreign assets and an increase in their net foreign liabilities. As a result of South African ownership of the banking sector and capital account liberalisation since 2003, the "net resident lending abroad" component is likely to remain more important for the financial account.

External Debt and Liquidity

External debt is almost all public. Around 80% is owed to multilateral institutions, 10% to bilateral creditors and the remainder to private creditors.

Around 70% of Lesotho's debt is on concessional terms.

The gross external debt to GDP ratio declined to 53% in 2004 from a peak of 85% in 2002, largely a reflection of the currency's appreciation against the USD. This year the government prepaid debt of around USD23m relating to the Post Office building and also made a net repayment on scheduled debt service. This led to a decline in nominal debt in 2005. The gross external debt to GDP ratio fell to 46% which is comparable with the 'BB' median of 41% of GDP. Nominal debt is projected to rise at a moderate pace thereafter, keeping external debt roughly stable in the medium term, at around 50% of GDP.

Lesotho's net external debt (NXD) ratios which typically benefit from high official reserves and net deposit money banks' foreign assets (DMBFA) (basically bank deposits in Lesotho invested in South Africa) have historically been very low. In 2004 the country became a net external creditor, a position it last enjoyed in 1998. This was largely owing to a substantial increase in DMBFA and a further increase in official reserves – the NXD to GDP and CXR ratios were both roughly around -0.2% at end-2004 projected to fall to around -4% in 2005. Similarly the liquidity ratio remains strong. Due to higher principal repayments in 2005, the debt service ratio will rise to 6.5% this year before falling back to around 5% over the medium-term.

Fiscal Accounts Summary*

% of GDP	2001/02	2002/03	2003/04	2004/05	2005/06f	2006/07f	2007/08f
Revenue & grants (excl. priv'n)	45.3	45.2	44.6	49.5	49.8	47.7	43.6
o/w SACU	21.9	19.9	17.7	22.4	24.0	22.4	18.5
o/w non SACU	14.3	15.0	18.2	18.6	18.1	18.0	18.0
o/w non tax revenue	6.2	6.2	6.6	5.7	5.6	5.3	5.1
o/w grants	2.9	4.0	2.2	2.7	2.1	2.0	2.0
Expenditure & net lending	44.7	49.6	43.8	45.5	48.9	47.2	48.1
o/w expenditure on goods & services	12.3	14.2	11.6	12.4	12.7	12.4	13.2
o/w wages & salaries	15.1	14.6	13.9	13.5	13.8	13.8	13.9
o/w current transfers & subsidies	4.7	6.9	7.8	9.3	10.5	10.1	9.8
o/w interest payments	3.1	3.0	2.7	1.6	1.8	1.8	2.0
Capital expenditure (incl. nationalisation expenses)	11.4	11.3	7.9	8.7	10.1	9.2	9.3
Primary balance (excl. interest)	1.7	-2.2	3.2	5.4	2.4	2.1	-2.7
Overall balance	0.7	-4.4	0.9	4.0	0.9	0.5	-4.5
Overall balance excluding grants	-2.2	-8.4	-1.4	1.3	-1.2	-1.5	-6.5
Financing:	0.7	4.5	-0.8	-4.0	-0.9	-0.5	4.5
Domestic	0.2	3.7	-0.5	-3.5	0.7	-0.6	4.7
External	0.5	0.8	-0.3	-0.5	-1.6	0.1	-0.2
Public debt*	101.4	73.8	65.1	53.0	44.4	42.9	45.0
Domestic	14.7	10.3	11.5	4.6	4.5	3.6	8.0
External	86.7	63.5	53.6	48.4	39.9	39.3	37.0
Public debt (% of revenue)	223.7	163.4	145.9	107.2	89.2	89.8	103.2
memo:							
interest service (% of revenue)	6.8	6.6	6.0	3.1	3.6	3.7	4.6

* All figures refer to the consolidated general government
 Source: IMF, Ministry of Finance, Fitch estimates and forecasts

Balance of Payments

(USDm)	2001	2002	2003	2004	2005f	2006f	2007f
Current account balance	-95.1	-126.7	-134.7	-76.0	-93.4	-103.9	-143.0
% of GDP	-12.5	-18.1	-12.7	-5.5	-6.4	-7.1	-9.1
Trade balance	-400.0	-405.5	-519.4	-594.7	-610.0	-620.0	-620.0
Exports, fob	278.6	357.3	475.0	707.3	660.0	690.0	720.0
(annual % change)	32.0	28.2	33.0	48.9	-6.7	4.5	4.3
Imports, fob	678.6	762.7	994.4	1302.0	1270.0	1310.0	1340.0
(annual % change)	-6.7	12.4	30.4	30.9	-2.5	3.1	2.3
Services, net	-8.5	-21.0	-35.0	-32.2	-29.8	-25.6	-25.0
Services, credit	40.5	34.9	50.0	63.9	65.2	72.4	80.0
Services, debit	49.0	56.0	85.0	96.1	95.0	98.0	105.0
Income, net	178.6	178.2	249.8	302.8	279.0	279.0	279.0
Income, credit	235.3	206.8	304.1	379.1	329.0	329.0	329.0
Income, debit	56.7	28.6	54.3	76.3	50.0	50.0	50.0
o/w: interest payments	13.5	12.9	14.1	26.2	25.0	25.0	25.0
Current transfers, net	134.7	121.6	169.9	248.1	267.4	262.7	223.0
o/w SACU revenues	113.7	118.5	143.0	223.1	245.0	240.0	200.0
Non-debt creating flows, net	117.0	84.1	115.7	123.5	94.0	99.0	99.0
Equity Direct investment, net	117.0	84.1	115.7	123.5	94.0	99.0	99.0
o/w Special Financing - LHWP.	88.5	56.5	73.5	71.5	40.0	45.0	45.0
Portfolio equity investment, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External borrowing, net	-3.7	11.6	-6.2	-1.4	-40.1	10.0	19.0
Net lending abroad	-20.2	1.5	-8.8	-48.9	-30.0	-30.0	-25.0
Capital nes, net	16.8	23.5	27.5	33.4	60.0	40.0	45.0
Net errors and omissions	155.4	-166.4	3.0	8.1	0.0	0.0	0.0
Overall balance = chg in reserves	170.2	-172.4	-3.6	38.8	-9.5	15.1	-5.0
memo:							
Gross borrowing (incl. short-term)	50.6	80.0	62.2	57.9	40.9	77.7	73.5
Gross external financing requirement	142.1	175.1	183.1	115.3	154.4	151.6	177.5
Stock of International reserves, excl. gold	386.5	406.4	460.3	502.8	520.0	530.0	530.0

Source: IMF IFS, FitchRatings estimates and forecasts

External Debt & Liquidity

(USDm)	2001	2002	2003	2004	2005f	2006f	2007f
Gross external debt	516.3	595.8	680.1	722.3	682.2	692.2	711.2
% of GDP	67.7	85.2	63.9	52.7	46.4	47.1	45.5
% of CXR	74.6	82.5	68.0	51.6	51.5	51.0	52.5
By maturity:	516.3	595.8	680.1	722.3	682.2	692.2	711.2
Medium- and long-term	496.3	575.8	660.1	702.3	662.2	672.2	691.2
Short -term	20.0	20.0	20.0	20.0	20.0	20.0	20.0
% total debt	3.9	3.4	2.9	2.8	2.9	2.9	2.8
By debtor:	516.3	595.8	680.1	722.3	682.2	692.2	711.2
Public sector	507.8	584.2	645.6	698.2	653.1	659.1	674.1
Private sector	8.5	11.5	34.6	24.1	29.1	33.1	37.1
By creditor:(Public sector)	507.8	584.2	645.6	698.2			
Multilateral	414.7	471.3	522.8	532.3			
Bilateral	51.7	60.7	68.5	66.5			
Commercial banks	31.4	34.7	38.2	50.1			
Other	18.5	29.1	50.6	73.4			
Gross external assets*	451.6	482.7	586.4	725.5	745.0	760.0	760.0
International reserves, incl. gold	386.5	406.4	460.3	502.8	520.0	530.0	530.0
Deposit money banks' foreign assets	65.1	76.3	126.1	222.7	225.0	230.0	230.0
Net external debt	64.7	113.1	93.7	-3.2	-62.8	-67.8	-48.8
% of GDP	8.5	16.2	8.8	-0.2	-4.3	-4.6	-3.1
% of CXR	9.4	15.7	9.4	-0.2	-4.7	-5.0	-3.6
Debt service (principal & interest)	60.5	61.3	62.5	65.5	86.0	72.7	59.5
Debt service (% of CXR)	8.7	8.5	6.2	4.7	6.5	5.4	4.4
Liquidity ratio (%)	735.1	555.5	585.0	685.9	684.5	803.7	955.5
excl. banks' foreign assets	616.4	475.4	492.6	538.4	474.4	560.9	666.3

* non-bank private sector external assets are not taken into account

Source: Ministry of Finance, World Bank Global Development Finance, Fitch estimates and forecasts

Amortisation Schedule on Medium- and Long-Term Debt

(USDm)	2005	2006	2007	2008	2009	2010
Public sector	61.0	47.7	34.5	35.3	33.1	34.0
o/w IMF	0.0	0.5	2.5	4.5	5.4	6.9
Other multilateral creditors	12.5	15.5	15.8	16.5	16.1	15.9
Bilateral creditors	17.1	15.4	3.8	3.8	3.0	3.0
Other	31.4	16.3	12.5	10.6	8.5	8.1

Source: Ministry of Finance

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